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C O N F I D E N T I A L TEGUCIGALPA 000518

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STATE FOR WHA/CEN, WHA/EPSC, EEB/OMA
TREASURY FOR ANNA JEWEL, SARA GRAY, AND WILLIAM FOSTER
STATE PASS TO USAID/LAC

E.O. 12958: DECL: 05/29/2018
TAGS: EFIN EAID ENRG EPET PGOV PREL IMF HO
SUBJECT: HONDURAS: IMF MISSION ASSESSES GOH RESPONSE TO EXTERNAL PRICE SHOCKS

REF: TEGUCIGALPA 242

Classified By: Ambassador Charles A. Ford, reasons 1.4 (b) and (d)

¶1. 1. (C) Summary: An IMF team that visited Honduras May 13-21 left satisfied with GOH efforts on the fiscal side to accommodate food and fuel price shocks. Meetings with the Central Bank on monetary policy were very tense, but the Central Bank followed IMF advice by raising its base interest rate by 25 basis points May 28 and permitting another micro-devaluation and may take further measures to prevent reserve losses and reduce inflationary pressures. Following the visit, the IMF resrep is cautiously optimistic that Honduras will meet the revised targets under its Precautionary Standby Agreement at the first quarterly review, which should take place in late July or early August. The IMF believes strict adherence to these measures could still result in economic growth of 3-4 percent this year. But the team left feeling that too much pressure from the IMF could be counterproductive and requested USG assistance in encouraging the GOH to implement sound economic policies. End Summary.

IMF Team Studies Impact of Price Shocks

¶2. (C) An IMF team visited Honduras May 13-21 to examine the effect of skyrocketing global food and fuel prices on the the Honduran economy and specifically on whether Honduras can meet the targets in the Precautionary Standby Agreement the IMF Board apaproved for Honduras in April. The trip was necessary, in part, because assumptions in the agreement, such as USD 85 per barrel oil, had proved to be too optimistic. IMF resrep Mario Garza told Econoff that authorities in the Finance Ministry and the national electric company, ENEE, were very open to IMF recommendations and appeared willing to continue to reduce unsustainable fuel and electricity subsidies. On the monetary side, Garza said discussions with Central Bank (BCH) President Edwin Araque were tense, even rising to the level of name-calling on one occasion. In the final meeting, however, Araque agreed to raise interest rates May 28 and work with the IMF on a plan to allow more exhange rate flexibility while avoiding excessive volatility and inflation.

Fiscal Policy Responding to Shocks

¶3. (C) Finance Minister Rebeca Santos and ENEE Director Rixi Moncada were very amenable to IMF suggestions on fiscal policy, recognizing that maintaining the current deficit level and making room for emergency spending would depend on limiting the cost of fuel and electricity subsidies. Fuel subsidies alone cost the GOH 1.4 billion lempiras (USD 74 million) through April, compared with 1 billion lempiras (USD 53 million) for all of 2007. Santos agreed to continue to allow pump prices to rise -- they have already increased around 17 percent in nominal terms over the last two months for diesel fuel and premium gasoline. She even agreed tentatively to raise the price of kerosene, used for cooking and lanterns by poor and isolated rural households. Garza said the price of regular gasoline, still frozen at 64 lempiras (USD 3.37) a gallon, would also go up soon.

¶4. (C) ENEE Director Moncada told IMF advisors she plans an electricity rate hike of 15 percent in June, a surprising announcement given it came before IMF recommendations were offered. Electricity rates have already been going up in stages since last December, for a cumulative increase of more than 40 percent for some customers, and the impact on household electric bills has become a major public discussion topic lately. The current price is consistent with a fuel oil (bunker) price of USD 82 per barrel, but the world price is currently hovering around USD 97. Fuel oil is used to produce about 70 percent of Honduras's electricity. Garza said that even after the 15 percent rate increase, ENEE would still be losing money on a cashflow basis, although he was not sure by how much. Thus, even as ENEE is paying down its old arrears to private power producers, it continues to accumulate new debt.

Market for GOH Debt

¶5. (C) Working closely with post's resident Treasury/OTA technical advisor, Santos has been very active in raising money through bond auctions to pay off old debt, almost all of which is from ENEE arrears. The GOH is currently on track to place bonds for 3.75 billion out of a needed 4 billion lempiras (USD 212 million) before the end of June. About 2.8 billion lempiras have already been placed, mostly to banks that already have ENEE debt in their porfolios and to pension funds. Due to unconventional reserve requirement policies set by the BCH, banks that focus on consumer credit have not participated. Demand for the bonds is dwindling and the May 27 auction for lempira-denominated bonds raised a paltry 200 million out of a hoped-for 1 billion lempiras. New bonds were offered for two, three, four, or five years (previously only three and five year bonds had been offered), but the bond rate has not been adjusted for inflation and the GOH has not been flexible about the yields needed to attract more banks to place bonds. The BCH also attempted this week to sell short term notes and managed to sell only 80 million out of a hoped for 1 billion lempiras. Banks did purchase more than 600 million lempiras worth of seven-day notes, indicating a preference to stay liquid. Subsequent bond auctions between now and June will be important measures of investor expectations about inflation.

Public Investment Faltering

¶6. (C) Due to overruns on fuel subsidies, only about one-third of the envisaged investment took place in the first quarter. Public investment thus not only fell short of the target in the IMF Agreement, it was significantly lower than the first quarter of 2007. The IMF team agreed that in order to strengthen the safety net, the GOH could reduce investment from 6.5 percent

to 5.3 percent of GDP. Half of this cut will be dedicated to programs to respond to rising food prices while the remainder will go to maintain fuel subsidies. While the IMF was discussing how to ensure spending is targeted and efficient, the GOH has already asked the World Bank for an emergency loan to address this issue. The discussion with the World Bank is centered on whether to use the loan on the demand side (to subsidize consumers) or the supply side (to increase food production). The Bank's preference is conditional cash transfers to the poorest and most affected parts of the population, while the GOH prefers to stimulate food production.

Central Bank Resists Austerity Measures

¶7. (C) BCH President Edwin Araque resisted IMF recommendations on the monetary front, often suggesting tepid substitute measures that Garza compared to closing the window against a tsunami. Araque complained that he would never succeed in selling tougher policies to President Zelaya. When Araque balked at raising the BCH benchmark rate (TPM), the team leader explained that consumer price inflation, including food, fuel and electricity rates, would inevitably exceed 12 percent within two months without tighter monetary policy. The IMF team recognized that increasing interest rates during a supply shock can create wage pressure that could push inflation to a higher, permanent plateau. But there is evidence that supply is starting to react slowly to rising commodity prices, which should help to moderate prices.

¶8. (C) Garza said that in the final meeting before the team departed May 21, Araque agreed to raise the monetary policy rate by 25 basis points on May 28. Garza worried that the lack of a press release might indicate Araque would go back on his word, but the rate increase was quietly implemented as scheduled.

¶9. (C) On the exchange rate, Araque attempted to impose a new operational rule within the BCH, in which the exchange rate could not move by more than 0.005 U.S. cents (0.11 lempira cents) per day. The IMF team told Araque this went against the spirit of flexibility within the exchange rate band, which is plus or minus 7 percent, and could create a black market or force a large interest rate increase. The team suggested that a reasonable rise in interest rates could help meet targets, and has designed a program of flexibility without huge day-to-day devaluations, which it shared with Araque, but Garza declined to describe the specifics until Araque agrees.

¶10. (C) Econoff inquired about the May 3 devaluation, which was implemented and retracted in the same day. Garza said Araque had implemented the devaluation by cutting dollar availability in auctions to 20 percent of usual levels starting April 27 for three days in a last ditch effort to meet the target for reserves at the end of April under the Standby Agreement. But he created a panic by calling bankers on the May 1 holiday and trying to convince them to buy more notes. Garza chalked it up to poor exchange rate management. Additional small devaluations have taken place in the last few days.

¶11. (C) Interim figures suggest the BCH is USD 70 million short of its June 30 reserve target. Garza said this is not a huge amount.

Cautious About Pushing Too Hard

¶12. (C) The IMF team left Honduras feeling the IMF cannot push too hard, because it could result in policy reversals in

several key areas. However, the team also recognized that the external food and fuel price shock is probably permanent, so it will need to help Honduras figure out how to pass price increases on to households while mitigating the impact on the poor. This will be especially important among urban populations, which benefit most from electricity and fuel subsidies and more likely to take to the streets to protest. Therefore, the IMF plans to help the GOH design a revised strategy that maintains the current deficit target (1.5 percent of GDP), while making room for emergency spending. Garza is pleased with the level of public outreach GOH has done to explain the electricity rate increases, and plans to talk to private sector and civil society groups to get political buy-in for some difficult but necessary decisions in the short term.

¶13. (C) The two sides signed an Aide Memoire at the conclusion of the mission with revised targets for the Standby Agreement, subject to approval by the IMF Board at the upcoming quarterly review. The GDP growth projection for 2008 has been reduced to 3.5-4.0 percent. The zero limit on non-concessional borrowing would be raised to accommodate borrowing for needed port improvements at Puerto Cortes. The GOH is seeking USD 160 million for this project; which is twice what the World Bank's IFC thinks it should realistically cost.

Comment

¶14. (C) The IMF team appears to have succeeded in convincing GOH technocrats, even the BCH president, of what needs to be done to maintain macroeconomic stability in Honduras. Obtaining approval from President Zelaya will be the biggest challenge. Garza requested that the USG praise Finance Minister Santos for her public outreach on fiscal policy, emphasizing to GOH officials, including Zelaya and Central Bank head Araque, that more tough decisions are to come and that we recognize the need to consider the effect on the poor. Post agrees that GOH backsliding on fiscal and monetary policy is a real possibility. At this time, the revised targets in the Aide Memoire may represent the best hope for keeping the GOH on a sustainable financial path. However, in reviewing the Aide Memoire, we recommend the USED raise questions about the cost estimates for upgrading Puerto Cortes and the refusal of the National Port Enterprise, headed by Zelaya ally Roberto Babun, to allow private investment in the port.

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